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IN THE

Supreme Court of the United States

COMMONWEALTH OF PENNSYLVANIA,
DEPARTMENT OF ENVIRONMENTAL PROTECTION,
Petitioner,

v.

JOSEPH P. NIGRO, TRUSTEE FOR THE ESTATE OF
TRI-STATE CLINICAL LABORATORIES, INC.,
Respondent.

Petition for Writ of Certiorari to the
United States Court of Appeals
for the Third Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Where a debtor commits a crime during the pendency of a Chapter 11 bankruptcy, is the resulting criminal penalty assessed against the debtor properly classified and prioritized as an administrative expense under the Bankruptcy Code?

LIST OF PARTIES

Petitioner is the Commonwealth of Pennsylvania, Department of Environmental Protection (DEP), which is the administrative agency of the Commonwealth of Pennsylvania charged with the administration of Pennsylvania's Solid Waste Management Act. At the time of the filing of the Proof of Claim in this matter, the DEP was known as the Department of Environmental Resources (DER), but was renamed the Department of Environmental Protection pursuant to Section 501 of the Pennsylvania Conservation and Natural Resources Act, Act of June 28, 1995 (No. 18, P.L. 89), 71 PA. STAT. ANN. § 1340.501. Since the Petitioner was the DER at the time of the filing of the Proof of Claim, the name DER was carried throughout the proceedings in the lower courts.

Respondent is Joseph P. Nigro, Trustee for the Estate of Tri-State Clinical Laboratories, Inc. The lower courts carried Tri-State Clinical Laboratories and the Trustee as joint appellees in the caption. Inasmuch as this Court is deciding the validity of the Trustee's objection to a claim, he is the real party in interest.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
LIST OF PARTIES	ii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
STATEMENT OF JURISDICTION	1
STATUTORY PROVISION INVOLVED	1
STATEMENT OF THE CASE	1
REASONS FOR GRANTING THE WRIT	3
I. A Criminal Penalty Imposed On A Bankruptcy Debtor In Possession Is An Administrative Expense Under The Bankruptcy Code And This Court Should Review The Third Circuit's Decision To The Contrary	3
A. The Third Circuit Departed From This Court's Decision In *Reading Co. v. Brown* When It Decided That Criminal Penalties Assessed For Conduct Engaged In During A Chapter 11 Proceeding Are Not An Administrative Expense	4
B. The Court Of Appeals Justified Its Departure From *Reading* By Misconstruing The Legislative History Of The Bankruptcy Code	7
C. The Third Circuit's Decision Renders 28 U.S.C. § 959(b) Inoperable	9
D. The Third Circuit's Decision Is Contrary To This Court's Policy That Federal Bankruptcy Courts Should Not Invalidate State Criminal Proceedings	10
E. The Third Circuit's Decision Stands Alone And Conflicts With The Authoritative Decisions Of All Other United States Courts Of Appeals That Have Addressed This Issue	11

TABLE OF CONTENTS—*(Continued)*

Page

CONCLUSION 16

APPENDIX

Commonwealth of Pennsylvania, Dep't of Envtl. Resources v. Tri-State Clinical Laboratories, Inc., No. 98-3332 (3d Cir. June 2, 1999) 1a

Commonwealth of Pennsylvania, Dep't of Envtl. Resources v. Tri-State Clinical Laboratories, Inc., No. 97-2115 (W.D. Pa. May 5, 1998) 26a

In re Tri-State Clinical Laboratories, Inc., No. 90-22476 (Bankr. W.D. Pa. August 21, 1997) 30a

Commonwealth of Pennsylvania, Dep't of Envtl. Resources v. Tri-State Clinical Laboratories, Inc., No. 98-3332 (3d Cir. July 21, 1999) 43a

Text of Statutory Provisions Involved 44a

11 U.S.C. § 503(b) 44a

11 U.S.C. § 93(j) *(repealed)* 45a

11 U.S.C. § 104(a)(1) *(repealed)* 45a

TABLE OF AUTHORITIES

Cases	*Page*
Alabama Surface Mining Comm'n v. N. P. Mining Co., Inc., (In re N. P. Mining Co., Inc.), 963 F.2d 1449 (11th Cir. 1992)	7, 11, 12
American Surety Co. v. Marotta, 287 U.S. 513 (1933)	12
Bank of Marin v. England, 385 U.S. 99 (1966)	11
Bates v. United States, 522 U.S. 23 (1997)	8
Cumberland Farms, Inc. v. Florida Dep't of Envtl. Protection, 116 F.3d 16 (1st Cir. 1997)	7, 12, 13
Fields v. Manns, 516 U.S. 59 (1995)	8
In re Bill's Coal Co., Inc., 124 B.R. 827 (D.Kan. 1991)	7
In re Charles Bank Laundry, Inc., 755 F.2d 200 (1st Cir. 1985)	13
In re Mammoth Mart, Inc., 536 F.2d 950 (1st Cir. 1976)	13
Kelly v. Robinson, 479 U.S. 36 (1986)	11
Midlantic Nat'l Bank v. New Jersey, 474 U.S. 494 (1986)	13
Oregon v. Witcosky, (In re Allen Care Centers, Inc.), 96 F.3d 1328 (9th Cir. 1996)	14
Pennsylvania Dep't of Pub. Welfare v. Davenport, 495 U.S. 552 (1990)	14
Reading Co. v. Brown, 391 U.S. 471 (1968)	*passim*
Springer v. Government of Philippine Islands, 277 U.S. 189 (1928)	8
United States v. Barnes, 222 U.S. 513 (1912)	8

TABLE OF AUTHORITIES—*(Continued)*

Cases, continued ***Page***

United States Dep't of Interior v. Elliott, 761 F.2d 168 (4th Cir. 1985) 7, 14

United States v. Noland (In re First Truck Lines, Inc.), 48 F.3d 210 (6th Cir. 1995), *rev'd.* 517 U.S. 535 (1996) 8

Federal Statutes

11 U.S.C. § 102(3) 12

11 U.S.C. § 503 ..... *passim*

11 U.S.C. § 726(a)(4) 7

28 U.S.C. § 959(b) 9, 10

28 U.S.C. § 1254 1

State Statutes

35 PA. STAT. ANN. § 6018.701 3

Pennsylvania Conservation and Natural Resources Act, Act of June 28, 1995 (No. 18, P.L. 89), 71 PA. STAT. ANN. § 1340.501 ii

Legislative Material

House Report No. 95-595, 95th Congress Second Session (1978), Reprinted in 1978 U.S.C.C.A.N. at 6311 14

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit which held that a criminal fine imposed on a corporation for engaging in egregious criminal conduct during the pendency of a Chapter 11 petition was not an administrative expense of the Chapter 11 bankruptcy estate.

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Third Circuit is reported at 178 F.3d 685 (3d Cir. 1999). A copy of the Opinion is reprinted in the Appendix at 1a. The Opinion of the United States District Court for the Western District of Pennsylvania is not reported, but is reprinted in the Appendix at 26a. The Opinion of the United States Bankruptcy Court for the Western District of Pennsylvania is not reported, but is reprinted in the Appendix at 30a.

STATEMENT OF JURISDICTION

The United States Court of Appeals for the Third Circuit issued its Opinion on June 2, 1999. On June 15, 1999, Petitioner filed a Petition for Rehearing and Suggestion for Rehearing *En Banc* that the United States Court of Appeals denied on July 21, 1999 (Appendix at 43a). This Petition for Writ of Certiorari is filed within ninety (90) days of the denial of the Petition for Rehearing. The Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254.

STATUTORY PROVISION INVOLVED

The relevant statutory provision is Section 503(b) of the United States Bankruptcy Code of 1978, 11 U.S.C. § 503(b). This statutory provision is reprinted in the Appendix at 44a.

STATEMENT OF THE CASE

This case involves a fundamental question of whether a criminal penalty, which is assessed by a state based upon egregious criminal conduct engaged in by a debtor during the pen-

dency of a Chapter 11 bankruptcy petition, is rightly classified and prioritized as an administrative expense under the Bankruptcy Code, thereby assuring payment of the criminal penalty. The underlying facts of the case are undisputed and relatively uncomplicated.

Criminal Conduct

On August 14, 1990, Tri-State Clinical Laboratories, Inc., filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code. Shortly after Tri-State Clinical filed its petition, on October 4, 1990, two municipal workers, Gary Brasco and Francis Eredintario, were emptying a municipal waste dumpster located behind Tri-State's facility into a municipal waste truck. After emptying the contents of the dumpster into the truck, Mr. Brasco engaged the truck's compactor. As the compactor crushed the contents of the dumpster, one of Tri-State's boxes broke open, spraying both workers with blood. The blood that sprayed the workers came from test tubes illegally dumped by Tri-State.

Criminal Proceedings

On January 21, 1992, Pennsylvania's Office of Attorney General filed a criminal complaint charging Tri-State with a violation of Pennsylvania's Solid Waste Management Act for illegally disposing of infectious waste. On July 28, 1994, Tri-State was convicted of violating Pennsylvania's Solid Waste Management Act and a $20,000 fine was assessed against Tri-State for illegally dumping infectious waste in a municipal dumpster.

Bankruptcy Proceedings

On September 10, 1992, respondent Joseph P. Nigro, was appointed Chapter 11 Trustee. Shortly thereafter, on October 6, 1992, Tri-State's bankruptcy case was converted to Chapter 7, and respondent Nigro was appointed Chapter 7 Trustee.

The Department of Environmental Protection ("DEP") filed a proof of claim[1] seeking to collect the $20,000 criminal penalty as a Chapter 11 administrative expense. The trustee, however, objected to treating the criminal penalty, which was assessed as a result of Tri-State's illegal dumping of infectious waste during the pendency of Chapter 11 proceedings, as an administrative expense. On April 9, 1997, a hearing was held before the bankruptcy court. At that hearing, it was concluded that the facts were undisputed and that the only question was whether the criminal penalty was properly classified as an administrative expense.

On August 21, 1998, the bankruptcy court entered an order sustaining the Trustee's objection to the proof of claim filed by the DEP. A timely appeal was taken by the DEP to the United States District Court for the Western District of Pennsylvania; however, on May 5, 1998, that court affirmed the bankruptcy court's decision.

An appeal was filed with the United States Court of Appeals for the Third Circuit. On June 2, 1999, the Court of Appeals held that the criminal penalty was not an administrative expense of the Chapter 11 bankruptcy estate. Petitioner's request for rehearing *en banc* was denied on July 21, 1999.

REASONS FOR GRANTING THE WRIT

I. A CRIMINAL PENALTY IMPOSED ON A BANKRUPTCY DEBTOR IN POSSESSION IS AN ADMINISTRATIVE EXPENSE UNDER THE BANKRUPTCY CODE AND THIS COURT SHOULD REVIEW THE THIRD CIRCUIT'S DECISION TO THE CONTRARY.

The question presented by this petition is clear cut and straightforward: Is a criminal fine imposed on a corporation for engaging in egregious criminal conduct during the pen-

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1. Although Pennsylvania's Office of Attorney General prosecuted this matter, DEP is the agency charged with administering Pennsylvania's Solid Waste Management Act and is entitled to all criminal fines collected under the Act. See 35 PA. STAT. ANN. § 6018.701.

dency of a Chapter 11 petition, in order to cut costs, properly classified as an administrative expense under Section 503 of the Bankruptcy Code. In this case, Tri-State chose to illegally dispose of infectious waste by dumping human blood into a municipal dumpster during the pendency of its Chapter 11 petition solely as a cost-cutting measure. Unfortunately, the Third Circuit's decision, by ignoring the text of the Bankruptcy Code and misconstruing legislative history to circumvent this Court's decision in *Reading Co. v. Brown,* 391 U.S. 471 (1968), encourages other debtors in possession to engage in similar cost-benefit analysis when deciding if they should comply with state and federal laws. Moreover, the Third Circuit's decision stands alone, in that it conflicts with every other authoritative decision of a court of appeals that has considered this issue.

A. The Third Circuit Departed From This Court's Decision In *Reading Co. v. Brown,* When It Decided That Criminal Penalties Assessed For Conduct Engaged In During A Chapter 11 Proceeding Are Not An Administrative Expense.

In *Reading,* this Court held that a tort judgment resulting from a trustee's negligence is entitled to a priority as an administrative expense. Specifically, the question presented in *Reading* was "whether the negligence of a receiver administering an estate under a Chapter XI arrangement gives rise to an 'actual and necessary' cost of operating the debtor's busines." *Reading Co.,* 391 U.S. at 476. Answering this question affirmatively, and thereby reversing the Third Circuit, this Court reasoned that injuries from the operation of a debtors business must be born by those creditors who benefit from the operation of the business under Chapter 11. *Id.* at 483-84. Notwithstanding this Court's analysis in *Reading,* however, the Third Circuit held that granting administrative status to a criminal penalty would be unfair because it would reduce the amounts otherwise available to pay innocent creditors. Appendix at 13a.

In its Opinion, the Third Circuit noted that this Court in *Reading* decided that the "necessary" cost of operating a business would include those "ordinarily incident" to its operations, and not just those without which rehabilitation would be impossible. Appendix at 6a. Nevertheless, the circuit court rejected the Commonwealth's argument that the cost of complying with the laws, including paying penalties for noncompliance, is a cost of doing business. It stated:

> We refuse to adopt an analysis of administrative expenses that is based upon the assumption that legitimate businesses engage in a "cost-benefit" analysis to determine if they will comply with criminal laws that protect the very public that the owners and operators of those legitimate business are a part of. It is neither reasonable nor necessary for a commercial enterprise to violate criminal laws and endanger the public to preserve the estate or to conduct legitimate business operations, and we refuse the DER's invitation to hold otherwise. Rather, we believe Congress intended only for those "actual, necessary costs and expenses" that arise in the context of . . . legitimate activity . . . to be . . . accorded priority as an administrative expense.

Appendix at 13a. This Court, in *Reading*, expressly rejected an argument almost identical to the one the Third Circuit accepted. In *Reading*, the trustee contended that the relevant statutory objectives are: "(1) to facilitate rehabilitation of insolvent businesses and (2) to preserve a maximum of assets for distribution among the general creditors should the arrangement fail." 391 U.S. at 476-77. Rejecting that view, this Court stated:

> In our view the trustee has overlooked one important, and here decisive, statutory objective: fairness to all persons having claims against an insolvent. Petitioner suffered grave financial injury from what is here agreed to have been the negligence of the receiver and a workman. It is conceded that, in

> principle, petitioner has a right to recover for that injury from their "employer," the business under arrangement, upon the rule of respondeat superior. Respondents contend however, that petitioner is in no different position from anyone else injured by a person with scant assets: it's right to recover exists in theory but is not enforceable in practice.
>
> That, however, is not an adequate description of petitioner's position. At the moment when an arrangement is sought, the debtor is insolvent. Its existing creditors hope that by partial or complete postponement of their claims they will through successful rehabilitation, eventually recover from the debtor either in full or in larger proportion then they would in immediate bankruptcy. Hence the present petitioner did not merely suffer injury at the hands of an insolvent business: it had an insolvent business thrust upon it by operation of law. . . .

Reading, 391 U.S. at 477-78. The *Reading* decision consequently requires those who will benefit from the debtor continuing in business to pay for the costs of that continuation in business.

In the present case, the Third Circuit turned the policy established by *Reading* on its head. Certainly the bankruptcy court would have approved the cost of proper disposal of infectious waste items; and had the debtor done so, the extra money spent on that disposal would not have been available to the creditors. Yet, creditors now stand to gain the money the debtors saved precisely because the debtor deliberately violated the law. It is particularly egregious in this case because the illegal dumping of human blood endangered not only the two municipal workers who were sprayed by the blood, but public health and safety generally.

Finally, it is worth noting that since this Court's decision in *Reading,* all other circuit courts have concluded that the post petition costs of complying with the law in a Chapter 11

bankruptcy is an administrative expense. *See Alabama Surface Mining Comm'n v. N. P. Mining Co., Inc., (In re N. P. Mining Co., Inc.),* 963 F.2d 1449 (11th Cir. 1992); *Cumberland Farms, Inc. v. Florida Dep't of Envtl. Protection,* 116 F.3d 16 (1st Cir. 1997); *United States Dep't of Interior v. Elliott,* 761 F.2d 168 (4th Cir. 1985); *In re Bill's Coal Co., Inc.,* 124 B.R. 827 (D.Kan. 1991). This Court should review the Third Circuit's contrary decision.

B. The Court Of Appeals Justified Its Departure From *Reading* By Misconstruing The Legislative History Of The Bankruptcy Code.

Seeking to justify its departure from *Reading,* the Third Circuit looked to legislative history that pertained solely to prepetition penalties. The present case by contrast involves criminal conduct undertaken during the course of the Chapter 11 bankruptcy. Thus, legislative history relating to prepetition penalties is simply inapposite to interpreting the statutory provisions relating to postpetition penalties.

The legislative history invoked by the Third Circuit relates only to 11 U.S.C. § 726(a)(4), which deals exclusively with prepetition penalties. Section 726(a)(4) provides:

> (a) Except as provided in . . ., property of the estate shall be distributed
>
> (4) Fourth in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture . . ., arising *before the earlier of the order for relief* or the appointment of a trustee, . . .

11 U.S.C. § 726(a)(4) (emphasis added). DEP is not arguing that prepetition penalties are entitled to Chapter 11 administrative claim status. Instead, this case only involves criminal penalties for conduct that occurred during Tri-State's Chapter 11 reorganization.

Ignoring the distinction between prepetition and postpetition penalties, the Court of Appeals isolated itself from the

context of the Bankruptcy Code and magnified the legislative history relating to prepetition penalties in order to demonstrate that Congress never intended for postpetition penalties to be classified as an administrative expense. The Third Circuit's misuse of legislative history in this way to bolster its conclusion and validate its misreading of this Court's precedent is simply astounding.[2]

A similar method of analysis was employed by the Sixth Circuit in *United States v. Noland, (In re First Truck Lines, Inc.),* 48 F.3d 210 (6th Cir. 1995), *rev'd* 517 U.S. 535 (1996), when the Sixth Circuit concluded that it should equitably subordinate postpetition tax penalties, simply because the Bankruptcy Code subordinated prepetition penalties. This Court soundly repudiated that case because Congress clearly had not seen fit to subordinate postpetition tax penalties and the courts have no right to reverse that conclusion. *See Noland,* 517 U.S. at 543. Congress clearly knew how to subordinate prepetition penalties; when it did not impose the same restrictions on postpetition penalties, it intended a different treatment.

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2. The Court of Appeals cites *Bates v. United States,* 522 U.S. 23 (1997), for support for its conclusion that criminal fines and penalties should not be treated as "administrative expenses" under the Bankruptcy Code. Appendix at 7a, n.4. Specifically, *Bates* stated "where Congress included particular language in one section of a statute but omits in another section of the same Act, it is generally presumed that Congress acts intentionally, and purposely in desperate inclusion or exclusion." 522 U.S. at 29-30.

This maxim of *expressio unis* "expresses a rule of construction and not of substantive law." *United States v. Barnes,* 222 U.S. 513 (1912). As such, *expressio unis,* must serve "only as an aid in discovering the legislative intent when that is not otherwise manifest." 222 U.S. at 519. Reliance on the maxim of *expressio unis* "must yield whenever a contrary intention on the part of the law maker is apparent." *Springer v. Government of Philippine Islands,* 277 U.S. 189, 206 (1928). In fact, the rule is "weakest when it suggests results strainly at odds with other textual pointers." *Field v. Manns,* 516 U.S. 59, 75 (1995). In this case, the text of section 503(b) makes clear that Congress never intended the list of administrative expenses to be comprehensive; instead, the list is merely illustrative.

C. The Third Circuit's Decision Renders 28 U.S.C. § 959(b) Inoperable.

The effect of the panel decision is that it totally emasculates the provision of 28 U.S.C. § 959(b), which requires that a debtor in possession operate a business in accordance with state laws. Section 959(b), provides as follows:

> . . . a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager *according to the requirements of the valid laws of the State* in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

28 U.S.C. § 959(b) (emphasis added). Thus, Congress expressly requires every debtor in possession to operate a business in accordance with state law.

In order to have any deterrent effect, criminal and civil penalties assessed during the pendency of a Chapter 11 petition must be treated as a cost and expense of doing business like any other expense. It is axiomatic that the purpose of a penalty is to encourage compliance with the law. Any deterrent effect, however, is lost if a debtor operating postpetition is allowed to do so with impunity, knowing that any penalty is characterized as a general unsecured claim and, therefore, in all probability will never be paid. Treating the criminal penalty as an administrative expense insures its payment, thereby reinforcing the deterrent effect by not allowing a debtor in possession and creditors to benefit from engaging in cost-cutting criminal behavior. Any other result gives a debtor in possession not only a distinct commercial advantage over those operating businesses outside bankruptcy, but an incentive to engage in criminal conduct to cut costs. Certainly this is not

what Congress intended when it specifically required a debtor in possession to comply with valid state laws.

The cost of complying, or the cost of paying a penalty for not complying with a law, are expenses incident to the operation of a business whether the business has filed for Chapter 11 reorganization or not. Indeed, any natural reading of Section 959(b) mandates that a penalty, whether criminal or civil, imposed for unlawful conduct by a debtor during the pendency of a Chapter 11 petition be granted priority as an administrative expense.

D. The Third Circuit's Decision Is Contrary To This Court's Policy That Federal Bankruptcy Courts Should Not Invalidate State Criminal Proceedings.

Contrary to the well-established policy of this Court, the Third Circuit's decision nullifies a criminal penalty imposed by Pennsylvania for conduct that occurred during the pendency of Tri-State's Chapter 11 bankruptcy petition. The Third Circuit's decision places great weight upon the fact that in a Chapter 7 bankruptcy there is only a finite amount of money available for creditors. Thus, for every dollar that is paid toward a criminal penalty in a Chapter 7 bankruptcy, there is one less dollar available to pay creditors. The Third Circuit's analysis is fundamentally flawed for two reasons.

First, it is much more important to insure that a Chapter 11 debtor has an economic incentive to obey the law than it is for federal courts to protect the resources available to pay creditors that had a business relationship with a debtor. Second, not every Chapter 11 bankruptcy proceeding converts to Chapter 7 and, in those cases that do not convert, the amount of money to pay creditors is not finite. Consequently, one must assume that the case will not convert from Chapter 11 to Chapter 7. Unfortunately, the Third Circuit's decision expresses more concern for protecting the resources available to creditors in Chapter 7 liquidation than with insuring that corporate debtors comply with state laws.

This Court has clearly set contrary policy through its decision in *Kelly v. Robinson*, 479 U.S. 36 (1986). In *Kelly*, this Court interpreted Section 523(a)(7) as prohibiting the discharge of criminal penalties assessed against *individuals*, reasoning that the basis for the exception to discharge is a deep conviction that federal bankruptcy courts should not invalidate state criminal proceedings. *Kelly*, 479 U.S. at 49. Quoting Justice William O. Douglas, this Court wrote:

> We do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principals govern the exercise of bankruptcy jurisdiction.

Id. quoting Bank of Marin v. England, 385 U.S. 99 (1966). This Court has long recognized that the states' interest in administering their criminal justice systems free from federal interference is one of the most powerful of the considerations that should influence a court considering equitable types of relief. "This reflection of our federalism must also influence our interpretation of the bankruptcy code." *Id.* Those words are a strong reminder of just how strictly this Court views the need to accord respect to a state's criminal proceedings.

E. The Third Circuit's Decision Stands Alone And Conflicts With The Authoritative Decisions Of All Other United States Courts Of Appeals That Have Addressed This Issue.

The Third Circuit was not the first court to address this issue, although its conclusion is unique. In fact, the Third Circuit recognized that its decision was in tension with other Circuit Court decisions but expressly chose to deviate from those opinions. Appendix at 22a.

The most comprehensive analysis of the status of Chapter 11 and Chapter 7 administrative fines and penalties was made by the Eleventh Circuit in *In re N. P. Mining Co.*, 963 F.2d 1449 (11th Cir. 1992). *N. P. Mining* involved a situation in which the debtor in possession violated environmental laws

while it was operating during the Chapter 11 administration of the bankruptcy case. Civil penalties were imposed upon the debtor as a result of those violations. On the basis of the civil penalties, the Alabama Surface Mining Commission filed an administrative claim pursuant to Section 503(b) of the Bankruptcy Code, which provides as follows:

> After notice and a hearing, there shall be allowed administrative expenses, . . . *including*
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, *including* . . .; (emphasis added)

The *N. P. Mining* court held that "punitive civil penalties assessed for postpetition mining activities qualify as an administrative expense under Section 503(b)(1)(A)." *N. P. Mining*, 963 F.2d at 1459. The rational used by the Eleventh Circuit was that there was a need to force trustees and "debtors in possession" to comply with state laws, pursuant to 28 U.S.C. § 959(b), and the Code's Rule of Construction contained in 11 U.S.C. § 102(3) relating to the word "including" in Section 503(b).[3] The *N.P. Mining* court concluded that "penalties assessed for mining violations that are sustained during the operation of a mine by the debtor in possession or the Trustee shall be given administrative expense status . . ." *Id.* at 1461.

The First Circuit in the case of *Cumberland Farms v. Florida Dep't of Envtl. Protection*, 116 F.3d 16 (1st Cir. 1997), took the same approach as the Eleventh Circuit. In *Cumberland Farms*, a network of combined convenience stores and gas stations located in Florida were operated by the debtor in possession. Cumberland Farms operated its underground storage tank sites after filing a Chapter 11 petition for a period of 17 months without complying with Florida's reporting requirements and pertinent regulations. Florida's DEP fined Cumberland Farms $200,000, which the bankruptcy court and district

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3. 11 U.S.C. § 102(3) is based upon this Court's decision in *American Surety Company v. Marota*, 287 U.S. 513 (1933).

court concluded had Chapter 11 administrative expense priority. The First Circuit, in affirming the district court, held:

> It is now abundantly clear that in state regulated areas such as protection of the environment, a bankruptcy court must comply with the laws of the state involved. [citation omitted] Debtors in possession, such as Cumberland, do not have carte blanche to ignore state and local laws protecting the environment against pollution. *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection,* 474 U.S. 494 (1986).

Cumberland Farms, 116 F.3d at 19-20. The First Circuit then found that under *Reading Co. v. Brown,* "the payment of a fine for failing during bankruptcy to meet the requirements of a state environmental protection law" is a cost "ordinarily incident to the operation of business in light of today's extensive environmental regulations." *Id.* at 20.

In coming to its conclusion in *Cumberland Farms,* the First Circuit reviewed this Court's decision in *Reading* and two of its prior rulings on similar questions. First, in *In re Charles Bank Laundry, Inc.,* 755 F.2d 200 (1st Cir. 1985), the First Circuit held that a fine for violation of a temporary injunction during the pendency of a bankruptcy was properly classified as an administrative claim. Second, in *In re Mammoth Mart, Inc.,* 536 F.2d 950 (1st Cir. 1976), the First Circuit found that administrative status should be given to claims of creditors injured by the debtor in possession's operations of the business if their claims did not arise from the transactions that were necessary to preserve or rehabilitate the estate. After reviewing *Reading* and its own prior precedent, the First Circuit affirmed the $200,000 Chapter 11 administrative expense priority holding that "it would be fundamentally unfair to allow *Cumberland Farms* to flout Florida's environmental protection laws and escape paying a penalty for such behavior." *Cumberland Farms,* 116 F.3d at 21.

The Third Circuit's decision is also contrary to and conflicts with that of the Fourth Circuit in *United States Dep't of Interior v. Elliott*, 761 F.2d 168 (4th Cir. 1985). *Elliott* involved a mining corporation operating as debtor in possession that was cited for several violations of the federal Surface Mining Conservation and Reclamation Act. Penalties were assessed for this postpetition conduct in the amount of $69,750. The lower courts in *Elliott* held that only tax penalties incurred by a Trustee while operating a debtor's business were allowable as postpetition administrative expenses. The Fourth Circuit rejected this holding and ruled that former Section 57 (j) of the bankruptcy act,[4] allowed "all postpetition penalty claims regardless of their type and regardless of whether they were incurred by the Trustee or by the debtor in possession." *Elliott*, 761 F.2d at 171.

Moreover, the fact that *N. P. Mining, Cumberland Farms,* and *Elliott* addressed civil penalties rather than criminal fines makes no difference as to a conflict between the circuits. Indeed, this Court specifically found in the case of *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 561-2, (1990), that there was no difference between the way criminal and civil sanctions were treated in the Bankruptcy Code.

Finally, the Third Circuit's decision leaves states in a quandary. The Ninth Circuit in *Oregon v. Witcosky, (In re Allen Care Centers, Inc.)*, 96 F.3d 1328 (9th Cir. 1996), held that the state could not recover costs incurred in providing care and safe transfer of residents after the closing of a failing nursing home, which was operated by the debtor, because the expenses were not a result of the debtors wrongdoing, but simply from its insolvency. *Witcosky*, 96 F.3d at 1331. Accordingly, in the Ninth Circuit, a state only receives administrative

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4. The fact that *Elliott* was decided under the former Bankruptcy Act rather than under the current Bankruptcy Code is of no consequence. Current Section 503(b)(1)(A) is virtually identical to former Section 64(a)(1) of the Bankruptcy Act, on which the claim in that case is based. The *Elliott* decision was not legislatively written out of the Bankruptcy Code and remains valid law today. *See* House Report No. 95-595, 95th Congress Second Session (1978), reprinted in 1978 U.S.C.C.A.N. at 6311.

expense priority if the debtor engages in wrongdoing. By contrast, in the Third Circuit, the very fact that there is a criminal violation bars the expense from being administrative. Currently, either all the other courts of appeals that have considered the issue and determined that penalties assessed by a state for illegal conduct engaged in during the pendency of a Chapter 11 petition are entitled to administrative expense status are wrong, or the Third Circuit is mistaken in its analysis in this case. Either way it is essential that this Court resolve this conflict.

CONCLUSION

For all the foregoing reasons, petitioner respectfully requests that this Court grant its Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

Respectfully submitted,

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APPENDIX

No. 98-3332

United States Court of Appeals for the Third Circuit

COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF ENVIRONMENTAL RESOURCES,
Appellants,

v.

TRI-STATE CLINICAL LABORATORIES, INC.,
JOSEPH NIGRO, Trustee,
Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA
Civil Action No. 97-cv-02115
District Judge: Hon. Donald J. Lee

Argued: January 26, 1999

Before: SLOVITER, McKEE, RENDELL, *Circuit Judges.*

(Filed June 2, 1999)

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OPINION OF THE COURT

McKEE, *Circuit Judge.*

We are asked to decide if a criminal fine is entitled to priority as an administrative expense under Chapter 7 of the Bankruptcy Code. The fine was imposed upon a debtor in possession for post-petition conduct that violated Pennsylvania's Solid Waste Management Act. Pennsylvania's Department of Environmental Resources ("DER") filed a proof of claim in which it asserted that it was entitled to have the fine paid as an administrative expense under § 503(b) of the Bankruptcy Code. The bankruptcy court disagreed, and sustained the trustee's objection to the proof of claim. The district court affirmed. We hold that a post-petition criminal fine is not an administrative expense under Chapter 7, and therefore we affirm.

I. Factual Background and Procedural History.

On August 14, 1990, Tri-State Clinical Laboratories, Inc. filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code. A few months later, on October 4, 1990, two municipal workers were sprayed with blood while emptying a dumpster located behind Tri-State's place of business. The blood came from test tubes that Tri-State had illegally placed in the dumpster. The test tubes would have been collected and deposited in a municipal landfill had they not been discovered.

On January 21, 1992, the Office of Attorney General filed a criminal complaint charging Tri-State with violations of Pennsylvania's Solid Waste Management Act for illegally disposing of infectious waste. Count I of the complaint charged Tri-State with unlawfully storing municipal waste on or about July 18, 1990 (before Tri-State had filed its Chapter 11 petition). Count II charged Tri-State with unlawfully disposing of infectious waste in the dumpster on or about October 4, 1990 (after Tri-State had filed its Chapter 11 petition).

On September 10, 1992, Joseph P. Nigro was appointed Chapter 11 Trustee. Shortly thereafter, on October 6, 1992, the case was converted to Chapter 7, and Mr. Nigro was appointed the Chapter 7 Trustee.

On July 28, 1994, while the Chapter 7 proceedings were still pending, the Court of Common Pleas of Westmoreland County convicted Tri-State on Counts I and II of the complaint and imposed a fine of $10,000 for the violation charged in Count I, and a fine of $20,000 for the violation charged in Count II. It is undisputed that these fines were punitive in nature, and unrelated to actual costs or expenses incurred by the DER.

On August 19, 1994, the DER filed a proof of claim asserting a $10,000 subordinated unsecured claim under 11 U.S.C. § 726(a)(4); and a $20,000 claim for administrative expenses pursuant to 11 U.S.C. §§ 503(b), 507(a)(1), and 726(a)(1).[1] The trustee objected to treating the $20,000 fine as an administrative expense. However, there was no objection to allowing the $ 10,000 claim for pre-petition conduct under 11 U.S.C. § 726(a)(4), and that fine is not an issue in this appeal.

The bankruptcy court concluded that administrative expenses must be claimed by filing a "request for payment," and not by filing a "proof of claim." Accordingly, the bankruptcy court held that "[its previous] order granting the DER leave to file its proof of claim beyond the bar date is, in effect, a nullity." In the alternative, the court held that the $20,000 fine for post-petition criminal conduct is not an administrative expense under § 503(b). Instead, the court allowed the DER to pursue the fine as an unsecured claim.

The district court subsequently affirmed the bankruptcy court's determination that the $20,000 fine was not an administrative expense. Thus, it was not necessary for the district court to decide if it agreed with the bankruptcy

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1. The bankruptcy court had previously granted the DER's motion to file a proof of claim beyond the bar date.

court's conclusion that an administrative expense must be asserted in a request for payment, rather than a proof of claim. This appeal followed.[2]

II. Discussion

A.

The DER contends that the $20,000 fine imposed upon the debtor in possession for conduct that occurred after it filed the petition must be given priority status as an administrative expense under § 503(b)(1)(A) of the Bankruptcy Code. The DER bases its argument upon the nonexclusive nature of the list of expenses in § 503(b), and the fact that other courts have held that tort damages, post-petition civil penalties, and civil environmental fines are administrative expenses. The DER insists that there is no rational basis to distinguish those civil penalties from these criminal fines. According to the DER, both must be treated as an "actual necessary expense of preserving the estate" under § 503(b). Appellant's Br. at 10. The DER seeks to bolster this argument with policy considerations. It insists that if criminal fines are not given priority, "Chapter 11 debtors in possession [will be encouraged] to disregard criminal statutes and other valid laws that might impede a debtor in possession's effort to turn a profit,"

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2. The district court's appellate jurisdiction was based on 28 U.S.C. § 15 8(a). We have jurisdiction pursuant to 28 U.S.C. § 158(c) and 28 U.S.C. § 1291. We exercise plenary review over a district Court's bankruptcy decision. *Universal Minerals. Inc. v. C.A. Hughes & Co.*, 669 F.2d 98, 100 (3d Cir. 1981). "Because the bankruptcy court, rather than the district Court, was the trier of fact in this case, we are in as good a position as the district court to review the findings of the bankruptcy court, so we review the bankruptcy court's findings by the standards the district court should employ, to determine whether the district court erred in its review." *In re Fegeley*, 118 F.3d 979, 982 (3rd Cir. 1997) (internal quotations omitted). Accordingly, we review the bankruptcy court's findings of fact for clear error, and exercise plenary review over legal issues. *Id.*

Although the parties have briefed the procedural issue of whether an administrative expense can be asserted in a proof of claim, that issue is not properly before us because it is not part of the district court's order. Moreover, because we conclude that the fines here are not administrative expenses, we need not decide whether the administrative expense claim was properly asserted.

because such a debtor can violate the law "secure in the knowledge that no economic punishment would follow." Appellant's Br. at 23-24. The DER warns that this would "create[] an incentive for any marginal corporate business to attempt to free itself from regulatory restraints by seeking the safe haven of Chapter 11 protection." *Id.* at 24.

The trustee's rejoinder relies heavily upon our decision in *Commonwealth of Pennsylvania Dept. of Environmental Resources v. Conroy*, 24 F.3d 568 (3d Cir. 1994).[3] The trustee argues that we drew a distinction in *Conroy* between compensatory assessments which may enjoy priority status as actual administrative expenses, and non-compensatory assessments which do not reimburse creditors for actual expenses. The trustee argues that because Congress expressly refers to non-compensatory criminal fines and penalties elsewhere in the Code, it would have expressly included such fines under § 503(b) if it intended to treat them as administrative expenses. The trustee also adds its own policy "spin" to rebut the policy considerations that the DER urges upon us. The trustee argues that non-compensatory criminal fines survive bankruptcy, and can be assessed against the corporation or corporate officers individually. Thus, those who are responsible for the operation of the business have no incentive to cut costs by violating the law as the DER suggests. Appellee's Br. at 24-25.

B.

The starting point of any statutory analysis is the language of the statute. *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 557-58 (1990); *Kelly v. Robinson*, 479 U.S. 40, 43 (1986). Thus, we begin at the beginning by examining the text of the statute. In doing so, "we must not be guided by a single sentence or member of a sentence, but look

3. Tri-State Clinical Laboratories and the trustee are jointly listed as "appellee" on the briefs and in the caption. Inasmuch as we are deciding the validity of the trustee's objection in the bankruptcy court we will refer to the appellee as the "trustee."

to the provisions of the whole law, and to its object and policy." *Kelly*, 479 U.S. at 43 (internal quotation marks omitted).

Section 503(b)(1)(A) of the Bankruptcy Code provides:

> (b) [T]here shall be allowed, administrative expenses, . . . including –
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. . .

11 U.S.C. § 503(b)(1)(A) (1997). Thus, for a claim to be given priority as an administrative expense under this provision of the Code, it must be (1) a "cost" or "expense" that is (2) "actual" and "necessary" to (3) "preserving the estate."

We construe the words of a statute according to their ordinary meaning, unless the context suggests otherwise. *See Moskal v. United States* 498 U.S. 103, 108 (1990); *Idahoan Fresh v. Advantage Produce. Inc.*, 157 F.3d 197, 202 (3d Cir. 1998). In *Reading Co. v. Brown*, the Supreme Court concluded that "the words 'preserving the estate' include the larger objective, common to arrangements, of operating the debtor's business with a view to rehabilitating it." 391 U.S. 471, 476-77 (1968). The dictionary defines "necessary" as "absolutely required" or "needed to bring about a certain effect or result." Webster's II New Riverside University Dictionary 787 (1994). However, the Supreme Court has held that the concept of "necessary costs" under the Code is somewhat broader than would be suggested by the dictionary definition. Thus, " 'usual and necessary costs' should include costs ordinarily incident to operation of a business, and not be limited to costs without which rehabilitation would be impossible." *Reading*, 391 U.S. at 483.

To determine Congress' intent in enacting § 503(b)(1)(A), we also must consider the other provisions of § 503. *See Neal v. Clark*, 95 U.S. 704, 708-09 (1978) ("a word is known by the company it keeps"). Section 503(b) specifically lists several expenditures that are included within the meaning of "administrative expenses." These include certain taxes and fines or penalties that relate to those taxes, *id.* at § 503(b)(1)(B) &

(C); compensation for services rendered by trustees and indenture trustees, *id.* at § 503(b)(2) & § 503(b)(5); the actual, necessary expenses incurred by certain creditors pressing their claims, *id.* at § 503 (b)(3); reasonable compensation for the professional services of attorneys and accountants who provide particular services, *id.* at § 503(b)(4); and other specified fees and mileage, § 503(b)(6). These specified administrative expenses all describe compensation for services that are necessarily incident to the operation of a business, *see, e.g.*, § 503(b)(2), (4) & (5), or reimbursement for actual expenses incurred, *see, e.g.*, § 503(b)(3) & (6).[4] Moreover, paragraph (1)(A) designates "wages, salaries, or commissions *for services rendered* after the commencement of the case" as "actual, necessary costs and expenses of preserving the estate." See § 503(l)(A) (emphasis added). Thus, the language of § 503(b), read as a whole, suggests a quid pro quo pursuant to which the estate accrues a debt in exchange for some consideration necessary to the operation or rehabilitation of the estate. Priority, therefore, is afforded such expenses to compensate the providers of necessary goods, services or labor.

Such a construction is supported by the purposes of the Bankruptcy Code. Chapter 11 is intended to "rehabilitat[e] the debtor and avoid[] forfeiture by creditors." *Pioneer Invest-*

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4. Although taxes incurred by the estate, as well as fines and penalties relating to those taxes, are expressly included in § 503's definition of administrative expense, taxes are treated uniquely throughout the Bankruptcy Code, and the policies underlying the treatment of taxes do not apply to other debts and expenses. Thus, the inclusion of taxes and tax penalties in this section is not particularly helpful to our analysis. Indeed, to the extent that the express reference to tax penalties in § 503 implies anything, it implies that Congress did not intend to include non-compensatory criminal fines and penalties within the category of "administrative expenses." Pursuant to well-established canons of construction, the fact that Congress expressly included tax fines and penalties in § 503 implies that had Congress intended to include other types of fines and penalties within the class of administrative expenses, it would have done so expressly. *See Bates v. United States*, 522 U.S. 23 (1997) (" '[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.' ") (quoting *Russello v. United States*, 464 U.S. 16, 23 91983) (other internal quotation marks omitted)).

ment Services, 507 U.S. at 389. The drafters of the Code recognized that to achieve that purpose, the debtor has to continue to operate between the filing of the petition and the adjudication of bankruptcy. This can result in additional expenses that are necessary to the continued operation of the business or to successfully winding it down. Congress recognized this need to provide an incentive to creditors who otherwise would not continue to provide services to a failing business. Accordingly, "the actual, necessary costs and expenses of preserving the estate" are given priority under the Code. *See* H.R. Rep. No. 95-595, at 186-187 (1977) *reprinted in* 1978 U.S.C.C.A.N. 5963, 6147 ("Those who must wind up the affairs of a debtor's estate must be assured of payment, or else they will not participate in the liquidation or distribution of the estate."); *id.* at 187, 1978 U.S.C.C.A.N. at 6147-6148 ("The purpose of [giving priority to wages earned within three months before bankruptcy,] as with the administrative expense priority, is in part to ensure that employees will not abandon a failing business for fear of not being paid."); Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. 93-137, pt. 1, at 214 (1973) [hereinafter "Commission Report to the House"] (recommending priority status for administrative expenses incurred during the reorganization period because "[s]uch expenses must be paid first to assure the availability of the services needed to administer a liquidation or reorganization case."). Absent the priority established under § 503, a debtor in possession could not keep its employees, nor obtain services necessary to its operation as it attempts to reorganize, or wind-down pending ultimate liquidation. We believe the relevance of this consideration extends to interpreting Congress' intent in according priority to certain claims under Chapter 7.

The Supreme Court's holding in *Reading* illustrates these principles. In *Reading,* I. J. Knight Realty Corporation filed a petition for an arrangement under Chapter 11 of the Bankruptcy Act which was then in effect.[5] The district court appointed a receiver, and authorized him to continue to con-

5. The prior Bankruptcy Act is analogous to the current version.

duct the debtor's business of leasing an industrial building. Thereafter the building was totally destroyed by a fire which spread to the surrounding property. In a resulting tort action, one of the adjacent property owners recovered a judgment against the receiver in an effort to obtain compensation for the damage the fire inflicted upon its property as a result of the receiver's negligence. Because the debtor in possession was in bankruptcy, an issue arose as to the priority that the judgment should be accorded against the bankrupt estate. The Supreme Court held that the tort Judgment was entitled to priority as an administrative expense under § 64a(l) of the Bankruptcy Act, 11 U.S.C. § 104(a)(1), even though the expense was not technically a cost of preserving the estate.[6]

The Court's holding was motivated by the considerations of fairness and practicality which underlie the purposes of the bankruptcy laws. The Court believed that those who continue to transact business with the debtor during the Chapter 11 case, and who suffer financially as a result, are entitled to priority over other creditors who have not affirmatively assumed such risk. The Court reasoned that fairness dictates that those injured by the operation of a bankrupt business by a receiver acting within the scope of his authority be compensated for the injury.

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6. Section 64a of the prior Bankruptcy Act defined administrative expenses in relevant part as follows:

> The debts to have priority, in advance of the payment of dividends to creditors and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, *including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition.* . . .

The Court concluded that it simply is not fair to deny innocent victims compensation for injuries they would not have incurred had the law not allowed the debtor to continue operating its business. Because *Reading* is so important to our inquiry we take the liberty of quoting the Court's opinion at length. The Court stated:

> In our view the trustee has overlooked one important, and here decisive, statutory objective: fairness to all persons having claims against an insolvent. Petitioner suffered grave financial injury from what is here agreed to have been the negligence of the receiver and a workman. It is conceded that, in principle, petitioner has a right to recover for that injury from their 'employer,' the business under arrangement, upon the rule of respondeat superior. Respondents contend, however, that petitioner is in no different position from anyone else injured by a person with scant assets: its right to recover exists in theory but is not enforceable in practice.
>
> That, however, is not an adequate description of petitioner's position. At the moment when an arrangement is sought, the debtor is insolvent. Its existing creditors hope that by partial or complete postponement of their claims, they will through successful rehabilitation, eventually recover from the debtor either in full or in larger proportion than they would in immediate bankruptcy. Hence the present petitioner did not merely suffer injury at the hands of an insolvent business: it had an insolvent business thrust upon it by operation of law. That business will, in any event, be unable to pay its fire debts in full. But the question is whether the fire claimants should be subordinated to, should share equally with, or collect ahead of those creditors for whose benefit the continued operation of the business (which unfortunately led to the fire instead of the hoped-for rehabilitation) was allowed.... The 'master,' liable for the negligence of the 'servant' in this case was the business operating under Chapter

> XI arrangement for the benefit of creditors and with the hope of rehabilitation. That benefit and that rehabilitation are worthy objectives. But it would be inconsistent both with the principle of respondeat superior and with the rule of fairness in bankruptcy to seek these objectives at the cost of excluding tort creditors of the arrangement from its assets, or totally subordinating the claims of those on whom the arrangement is imposed to the claims of those for whose benefit it is instituted.
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> * * *
>
> In considering whether those injured by the operation of the business during an arrangement should share equally with, or recover ahead of, those for whose benefit the business is carried on, the latter seems more natural and just. Existing creditors are, to be sure, in a dilemma not of their own making, but there is no obvious reason why they should be allowed to attempt to escape that dilemma at the risk of imposing it on others equally innocent.

391 U.S. at 477-83.

The Court also considered the practical consequences of not allowing the tort claimant to recover ahead of other creditors.

> More directly in point is the possibility of insurance. An arrangement may provide for suitable coverage, and the Court below recognized that the cost of insurance against tort claims arising during an arrangement is an administrative expense payable in full under § 64a(l) . . . It is . . . obvious that proper insurance premiums must be given priority, else insurance could not be obtained; and if a receiver or debtor in possession is to be encouraged to obtain insurance in adequate amounts, the claims against which insurance is obtained should be potentially payable in full.

Id. at 483.

> Thirdly, the Court considered the background of tort law. It has long been the rule of equity receiverships that torts of the receivership create claims against the receivership itself; in those cases the statutory limitation to "actual and necessary costs" is not involved, but the explicit recognition extended to tort claims in those cases weighs heavily in favor of considering them within the general category of costs and expenses.

Id. at 485. The Court concluded that, because the torts of a receivership create claims against the receiver, it could not distinguish between claims arising from conduct which is integral to the operation of the business, and torts arising from "nonessential" activity.

> No principle of tort law of which we are aware offers guidance for distinguishing, within the class of torts committed by receivers while acting in furtherance of the business, between those "integral" to the business and those that are not.... We hold that damages resulting from the neligence of a receiver acting within the scope of his authority as receiver give rise to "actual and necessary costs" of a Chapter XI arrangement.

Id. Inasmuch as the receiver was acting within the scope of its authority, the demands of fair compensation required that persons who were injured by the receiver's negligence be compensated. This, in turn, required giving their claims priority over the claims of other creditors.[7]

Here, allowing the DER's claim to be treated as an administrative expense will allow that claim to be paid to the

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7. We realize that the debtor in *Reading* was seeking an arrangement under Chapter 11, and the Court reached its holding in that context. Here, of course, the defendant initially filed for the contemporary counterpart of an arrangement — a reorganization — under Chapter 11, and the case was thereafter converted to a liquidation ("straight bankruptcy" using the terms of the prior Bankruptcy Act). However, we think this is a distinction without a difference. In *Reading* the Court noted: "It is agreed that this section [64a] applicable by its terms to straight bankruptcies, governs payment of administration expenses of Chapter XI arrangements". 391 U.S. at 475.

exclusion of, and out of the resources otherwise available for, claims of other creditors. The practical result would be that fines for committing crimes would be paid by innocent third persons — the creditors — rather than Tri-State — the criminal. That is as unfair as it is impractical. The payment of the criminal fine would not compensate for any damages resulting from Tri-State's conduct. It would merely cause Tri-State to satisfy its obligations to the state out of the pockets of Tri-State's creditors.

The DER argues that the cost of complying with the criminal laws is a necessary cost of doing business (no less than taxes, wages, or fees), and therefore any criminal penalties in the form of fines resulting from violating the law must be treated as an administrative expense. Thus, the DER would have us hold that a violation of a criminal law intended to protect public safety is necessary or ordinarily incident to operating a business, and therefore, is incurred as an expense of "preserving the estate." However, the DER fails to recognize that, even if the costs associated with operating a business in accordance with the law are necessary to preserving the estate, it does not follow that criminal fines and the conduct they attempt to punish are ordinarily incident to operating a business. We refuse to adopt an analysis of administrative expenses that is based upon the assumption that legitimate businesses engage in a "cost-benefit" analysis to determine if they will comply with criminal laws that protect the very public that the owners and operators of those legitimate businesses are part of. It is neither reasonable nor necessary for a commercial enterprise to violate criminal laws and endanger the public to preserve the estate or to conduct legitimate business operations, and we refuse the DER's invitation to hold otherwise. Rather, we believe Congress intended only for those "actual necessary costs and expenses" that arise in the context of, or compensate for, legitimate business activity, or the losses resulting therefrom, to be treated as expenses of preserving the estate, and accorded priority as an administrative expense.

Although both parties to this appeal rely upon our holding in *Conroy, supra,* to suport their arguments, we view *Con-*

roy as supporting the distinction we draw between claims for compensatory expenses and those for criminal fines. In *Conroy,* the DER filed a claim for reimbursement for costs incurred in cleaning up hazardous chemicals at a site the Chapter 11 debtors had attempted to abandon. In holding that those costs were administrative expenses entitled to priority we said:

> [I]f the DER had not itself undertaken to clean up the [site,] the Conroys could not have escaped their obligation to do so by abandoning the hazardous property in question. Furthermore, if Frank Conroy had arranged for cleanup of the facility after he had filed a Chapter 11 petition, the costs of this cleanup would have constituted administrative expenses under 11 U.S.C. § 503(b)(1)(A), since they are a portion of 'the actual, necessary costs and expenses of preserving the estate.'

Id. at 569. We also held that reimbursement for that portion of the administrative and legal costs incurred in arranging for cleanup which the DER had "sufficiently substantiated" as reasonable compensation also qualified as an administrative expense. *Id.* at 570-71. By cleaning up the site, the DER provided a service to the debtor — a service that the debtor itself would have had to perform during the course of normal operations — and therefore, the DER was entitled to compensation for that service.

The situation here is quite different. Tri-State was not required to endanger the health and welfare of residents of the community by illegally disposing of test tubes containing blood, and the sanction that was imposed as punishment for doing so has nothing to do with compensation or proper business operations. Rather the purpose of this criminal fine is deterrence, retribution, and punishment.

C.

Our conclusion is also consistent with the legislative history relating to the classification of non-compensatory criminal fines and penalties. Before Congress replaced the

Bankruptcy Act of 1898 with the current Bankruptcy Code, a creditor had to show that a claim was both "allowable" (under § 57 of that Act), and "provable" (under § 63 of that Act) before the creditor could participate in the distribution of assets at all. *See* H.R. Doc. 93-137, pt. 1, at 21 (1973); *Kelly v. Robinson,* 479 U.S. 36, 44-45 (1986). Section 57(j) specifically excluded criminal penalties from the class of allowable debts insofar as they did not compensate for an actual loss. Section 57(j) of the Act provided:

> Debts owing to the United States, a State, a county, a district, or a municipality as a penalty or forfeiture shall not be allowed, *except for the amount of the pecuniary loss sustained by the act,* transaction, or proceeding out of which the penalty or forfeiture arose.

30 Stat. 561 (emphasis added). Section 63 defined "provable" debts to include criminal penalties. Thus, by the early 1970s, when Congress began reexamining the bankruptcy laws, it was well established that criminal fines were not allowable debts subject to distribution from the estate under Chapter 7.[8]

In 1973, the Commission on the Bankruptcy Laws of the United States, which was established to propose changes to the bankruptcy laws, recommended combining the concepts of "allowable" and "provable" claims into a single enlarged class of "allowable" claims. H.R. Doc. No. 93-137, pt.1, at 21. The Commission also recommended subordinating certain claims to other unsecured claims within that large class. Among this class of subordinated claims were claims specified in § 4-406(a) of the proposed bill, including "any claim, whether secured or unsecured, to the extent it is for a fine, penalty or forfeiture or for multiple, punitive or exemplary claims." *Id.* at 22 and pt. 2, at 115. The Commission recommended changing the law to subordinate such claims, rather than disallowing them, "to

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8. Tri-State's bankruptcy is an example of the frequency with which cases begun under Chapter 11 eventually convert to Chapter 7. We do not think that the conversion from Chapter 11 to Chapter 7 alters our analysis. *See Reading, supra* (noting that the provisions for straight bankruptcies govern priority under an arrangement under the prior Code).

prevent the debtor from obtaining a windfall of a disallowance intended only to benefit its creditors." *The Bankruptcy Reform Act: Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong. 761 (1975) [hereinafter "Hearings S. 235"]. In that same Report, the Commission also recommended establishing three categories of priority claims: (1) administrative expenses, which the Commission explained "must necessarily be given first priority in order for estates to be liquidated and any distributions made to any creditors"; (2) wages; and (3) taxes accruing within one year prior to bankruptcy. H.R. Doc. 93-137, pt.1, at 21.

Based on the Commission's recommendations, the House and the Senate drafted bills which provided for subordinating and prioritizing certain kinds of claims. The relevant provision, which was set forth in § 4-406 in both bills, expressly subordinated any claim for a fine, penalty, or multiple, punitive, or exemplary damages. *See* H.R. 10792, 93rd Cong. (1973); S. 236, 94th Cong. (1975). In prepared remarks before the Senate subcommittee drafting the proposed legislation, the Commission explained that this subordination "is derived from sec. 57 of the present Act which disallows fines, penalties, and forfeitures owing the government. This provision simply subordinates. *It won't change the result in many cases* but prevents any return to a solvent debtor who has incurred a penalty and extends the principle to exemplary and [sic] damages." Hearings S. 235 at 15 (emphasis added).

In drafting the current Bankruptcy Code, Congress considered the policy ramifications of subordinating criminal penalties to unsecured debts. During congressional hearings the Assistant Attorney General for the Civil Division of the Department of Justice argued that criminal judgments should not be subordinated, stating: "Fine judgments represent a solemn judgment rendered against a debtor for a crime against society. The fine debtor has not paid his debt to society until the fine is satisfied. As a matter of public policy such judgments should at least share priority with the Government's non-tax claims and not be subordinated." Hearings S. 235 at 478. The American Life Insurance Association argued to the

contrary: "[The Civil Division] overlooks the fact that in a bankruptcy situation, the other creditors in effect end up paying the fine if it is not subordinated. For that reason, it should not be paid out of the estate unless all other claims (subordinated or unsubordinated) are first paid in full." *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong. 1590-91 (1976). Similarly, the Securities and Exchange Commission recommended deleting § 4-406 entirely and substituting in its place § 57(j) of the original Bankruptcy Act, which disallowed fines and penalties. Hearings S. 235 at 736. The SEC favored disallowance over subordination because it feared that subordinated fines and penalties would still take priority over the interests of stockholders. *Id.*

The statute as enacted did not include a separate section covering subordinated claims. Instead, Congress enacted § 726, "Distribution of property of the estate," which "dictates the order in which [sic] distribution of property of the estate, which has usually been reduced to money by the trustee under the requirements of section 704(l)." S. Rep. No. 95-989, at 96-97 (1978). Section 726 provides in relevant part:

> (a) . . . [P]roperty of the estate shall be distributed —
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title [referring to administrative expenses under § 503];
> (2) second, in payment of any allowed unsecured claim . . . proof of which is [timely filed under sections 501(a), (b), or (c), or tardily filed under section 501(a)];
> (3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) . . .;
> (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the

> order for relief or the appointment of a trustee, to the extent such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;
> (5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and
> (6) sixth, to the debtor.

11 U.S.C. § 726. The Senate explained paragraph (4) as follows:

> Fourth, distribution is to holders of fine, penalty, forfeiture, or multiple, punitive, or exemplary damage claims. More of these claims are disallowed entirely under present law. They are simply subordinated here. Paragraph (4) provides that punitive penalties, including pre-petition tax penalties, are subordinated to the payment of all other classes of claims, except claims for interest accruing during the case. *In effect, these penalties are payable out of the estate's assets only if and to the extent that a surplus of assets would otherwise remain at the close of the case for distribution back to the debtor.*

S. Rep. No. 95-989 at 97 (emphasis added). Thus, prepetition fines were accorded second class status in the distribution scheme.

This provision works in tandem with § 523 of the current version of the Code, which governs the dischargeability of debts at the conclusion of the bankruptcy proceedings. To understand § 523, however, it is useful to understand its history as well. Section 17 of the old Bankruptcy Act provided that a discharge in bankruptcy released a debtor from all provable debts at the conclusion of the bankruptcy case with four specified exceptions. Although criminal penalties were not excepted from discharge under § 17, courts historically had refused to discharge state criminal penalties under federal bankruptcy because of considerations of comity. *See Kelly,* 479

U.S. at 44-46. In 1978, Congress codified this judicial exception to dischargeability of criminal fines and penalties in § 523. That section, entitled "Exceptions to Discharge," provides:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt —
> . . . (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, . . .

11 U.S.C. § 523(a)(7); *see also* FRBP Official Form 18 (9/97), Explanation of Bankruptcy Discharge in a Chapter 7 Case ("Some of the common types of debts which are not discharged in a chapter 7 bankruptcy case are . . . [d]ebts for most fines, penalties, forfeitures, or criminal restitution obligations.").

The Supreme Court explained the evolution of this exception to discharge in *Kelly v. Robinson,* 479 U.S. 40 (1986). In that case, a defendant was ordered to pay restitution as a condition of probation after pleading guilty to welfare fraud. After she was sentenced, she filed a voluntary petition in bankruptcy under Chapter 7 listing the restitution obligation as a debt. The appropriate state agencies did not file a proof of claim in the court for the outstanding restitution, but the bankruptcy court nevertheless ruled that the restitution payments were not dischargeable under § 523(a)(7) of the Code. The court held that, even though restitution reimburses the victim of criminal activity, its purpose is rehabilitation, and not compensation. Thus, the criminal statute focused " 'upon the offender and not the . . . the victim, . . . restitution is part of the criminal penalty rather than compensation for a victim's actual loss.' " *Kelly,* 479 U.S. at 41. The district court agreed, but the Court of Appeals for the Second Circuit reversed. It held that restitution was a "debt" as that term was defined in the Bankruptcy Code. It relied upon legislative history to conclude that "Congress intended to broaden the definition of "debt" from the narrower definition of the Bankruptcy Act of 1898." *Id.* The Court of Appeals further concluded that the

restitution was discharged under § 523(a)(7), which provides for automatic discharge of certain debts. The Supreme Court reversed, relying in part on an opinion the New York Supreme Court had reached four years before Congress enacted the current Bankruptcy Code. The Supreme Court stated:

> A discharge in bankruptcy has no effect whatsoever upon a condition of restitution of a criminal sentence. A bankruptcy proceeding is civil in nature and is intended to relieve an honest and unfortunate debtor of his debts and to permit him to begin his financial life anew. A condition of restitution in a sentence of probation is a part of the judgment of conviction. It does not create a debt nor a debtor-creditor relationship between the persons making and receiving restitution. As with any other condition of a probationary sentence, it is intended as a means to insure the defendant will lead a law-abiding life thereafter.
>
> Thus, Congress enacted the Code in 1978 against the background of an established judicial exception to discharge for criminal sentences . . . an exception created in the face of a statute drafted with considerable care and specificity.

479 U.S. at 46 (internal quotation marks and citations omitted).

Four years later the Supreme Court elaborated upon the holding in *Kelly,* and emphasized the extent to which the purpose of the Code was relevant to determining dischargeability. In *Pennsylvania Department of Public Welfare v. Davenport,* 495 U.S. 552 (1990), the Court held that, even though restitution payments were not discharged under Chapter 7, such payments were dischargeable "debts" under Chapter 13. The Court explained:

> [I]n locating Congress' policy choice regarding the dischargeability of restitution orders in § 523(a)(7), *Kelly* is faithful to the language and structure of the Code: Congress defined "debt" broadly and took

> care to except particular debts from discharge where policy considerations so warranted. Accordingly, Congress secured a broader discharge for debtors under Chapter 13 than Chapter 7 by extending to Chapter 13 proceedings some, but not all, of § 523(a)'s exceptions to discharge.... Among those exceptions that Congress chose not to extend to Chapter 13 proceedings is § 523(a)(7)'s exception for debts arising from a "fine, penalty, or forfeiture." Thus, to construe "debt" narrowly in this context would be to override the balance Congress struck in crafting the appropriate discharge exceptions for Chapter 7 and Chapter 13 debtors.

495 U.S. at 562-3.

We conclude that the policy considerations evidenced by the aforementioned legislative history, as well as the text of the Code and the cases interpreting it, support our view that non-compensatory criminal fines imposed on a Chapter 7 debtor or trustee should not be deemed administrative expenses. This interpretation also is consistent with Congress' limitation on the dischargeability of criminal fines and penalties. Under Chapter 7, that portion of a fine that is compensatory is discharged. 11 U.S.C. § 523(7). *See Davenport*, 495 U.S. at 559 ("The Court in *Kelly* analyzed the purposes of restitution in construing the qualifying clauses of § 523(a)(7), which explicitly tie the application of that provision to the purpose of the compensation required."). We do not believe that Congress intended for us to ignore the non-compensatory character of a criminal fine in deciding if it is an administrative expense under § 503, while explicitly requiring that consideration under § 523(7). Rather, for the reasons previously stated, we conclude that § 503's restriction to "expenses of preserving the estate" limits such expenses to those that constitute compensation for expenditures necessary to the operation of the debtor-in-possession's business. As we noted above, we will not stretch our policy analysis to include within this category the payment of the criminal fines for Tri-State's conduct here.

We recognize, of course, that Tri-State may not have the funds to pay this fine after the estate is liquidated. However, that is often a possibility when criminal fines are imposed, and we see nothing in the statutes that Tri-State has violated, nor anything endemic to the process of bankruptcy, that would justify us in removing the Commonwealth's hand from the empty pockets of the criminal, and placing it in the pockets of creditors merely because those pockets are deeper. Tri-State was sentenced while in bankruptcy for an act that occurred after it filed its bankruptcy petition. The sentencing judge clearly knew that Tri-State's ability to pay any fine was suspect at best. Yet, the sanction here was on the corporate entity, not upon the responsible individuals. It should not now come as any great surprise that the bankrupt debtor lacks the resources to pay this criminal fine and meet its obligations to creditors. Tri-State's precarious financial condition does not, however, allow us to stretch the concept of administrative expense to remedy the DER's predicament.

D.

Finally, we realize, of course, that there is a certain tension between our analysis here, and the analysis in *N.P. Mining Co. v. Alabama Surface Mining Commission*, 963 F2d. 1449 (11th Cir. 1992). There, the court held that civil fines imposed solely as punishment for violation of environmental regulations were entitled to priority as an administrative expense under Chapter 11. The holding was based upon the requirement in § 969(b) that the trustee or debtor in possession manage and operate the property in compliance with state law. The court of appeals reasoned that

> [i]f postpetition costs "ordinarily incident to operation of a business" that do not confer a benefit on the estate [the tort claims in *Reading*] can indeed qualify as "actual, necessary" expenses of preserving the estate, then a strong case can be made that when a licensed business operates in the regulated atmosphere of strip mining in Alabama, incurring regulatory penalties is a cost ordinarily incident to

> operation of a business and should be accorded administrative-expense priority.

Id at 1454-5.

However, we do not think that rationale applies here, even if it is appropriate for a civil fine on a business in a heavily regulated industry. As noted above, doing so would require us to infer that disposing of infectious human waste in a manner that not only endangers members of the general public, but also constitutes criminal activity, is part of the ordinary and necessary operations of a business. Moreover, the court in *N.P. Mining* stressed that the violation before it did not involve safety. *See N.P. Mining,* 963 F-2d at 1458 ("Here, there is no threat to public health or safety."). We are not convinced the court's holding would be the same if it were faced with the kind of reckless conduct in which Tri-State engaged. Finally, the court in *N.P. Mining* did not consider the extensive legislative history regarding prepetition penalties to be as relevant as we do in determining whether punitive criminal fines should be given preferential treatment. *See id.* at 1452 (stating "[t]he legislative history of section 503(b) as well as the legislative history of other relevant sections of the Bankruptcy Code, is silent regarding the treatment of punitive post petition penalties"). Accordingly, we are not persuaded by *N.P. Mining,* the cases upon which it relies, or the cases that have relied upon *N.P. Mining. See, e.g., In re Bill's Coal Company, Inc.,* 124 B.R. 827 (D. Kan. 1991); *In re Charlesbank Laundry, Inc.,* 755 F-2d 200 (1st Cir. 1985); *In re Double B Distributors, Inc.,* 176 B.R. 271 (Bky. M.D.Fla. 1994); *In re Motel Investments, Inc.,* 172 B.R. 105 (Bky. M.D.Fla. 1994).

III. Conclusion

In sum, based on the plain language of the Bankruptcy Code, its purpose and legislative history, and the principles of fairness upon which the Code is grounded, we hold that punitive criminal fines arising from post-petition behavior are not administrative expenses under 11 U.S.C. § 503(b), and therefore, are not accorded priority status pursuant to § 507(a)(1). Therefore, the orders of the Bankruptcy Court and the District Court will be affirmed in accordance with this decision.

No. 98-3332

United States Court of Appeals for the Third Circuit

COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF ENVIRONMENTAL RESOURCES,

v.

TRI-STATE CLINICAL LABORATORIES, INC.,
JOSEPH NIGRO, *Trustee,*

THE COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF ENVIRONMENTAL RESOURCES,

Appellant

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

(D.C. No. 97-cv-02115)
District Judge: Honorable Donald J. Lee

ARGUED BY COUNSEL
January 26, 1999

Present: Sloviter, McKee and Rendell, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Western District of Pennsylvania and was argued by counsel January 26, 1999.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court entered May 5, 1998, be, and the same is hereby affirmed. Costs taxed against the appellants. All of the above in accordance with the opinion of this Court.

ATTEST:

/s/ P. Douglas Sisk
Douglas Sisk
Clerk

Dated: June 2, 1999

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

COMMONWEALTH OF PENNSYLVANIA, DEPARTMENT OF ENVIRONMENTAL RESOURCES,	)	
Appellant,	)	Civil Action No. 97-2115
	)	Bankruptcy Court
vs.	)	No. 990-22476/JLC
TRI-STATE CLINICAL LABORATORIES, INC.,	)	
Appellee	)	

MEMORANDUM OPINION

May 5, 1998

Before the Court is the appeal of the Commonwealth of Pennsylvania Department of Environmental Protection from the final order of the United States Bankruptcy Court for the Western District of Pennsylvania dated August 21, 1997, holding that a $20,000 criminal fine assessed for post-petition conduct is not an administrative claim under Section 503(b) of the United States Bankruptcy Code, 11 U.S.C. § 503(b) and that the claim shall be allowed as an unsecured claim.

On August 14, 1990, Tri-State Clinical Laboratories, Inc. ("Debtor") filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code. On January 21, 1992, a criminal complaint was filed against the Debtor for violation of Pennsylvania Solid Waste Management Act. Count 1 of the complaint accused the Debtor of unlawfully storing municipal waste on or about July 18, 1990, and Count 2 charged that on or about October 4, 1990, the Debtor disposed of infectious waste in a municipal waste dumpster in violation of the Pennsylvania Solid Waste Management Act.

The Chapter 11 trustee, Joseph P. Nigro, was appointed on September 10, 1992. On October 6, 1992, the case was converted to Chapter 7 and again Joseph P. Nigro was appointed Chapter 7 trustee on December 1, 1992.

On July 28, 1994, the Debtor was found guilty on both counts of the criminal complaint before the Court of Common Pleas of Westmoreland County. The Debtor ceased to operate around August of 1991 and apparently the trustee was not noticed as to the proceeding. However, the Debtor did appear by counsel and either pled guilty or nolo contendere to both counts, and the Court of Common Pleas of Westmoreland County ordered the Debtor, and not the trustee, to pay the criminal fine of $20,000 on Count 2 which is the claim at issue here.

On June 1, 1994, the DER filed a motion for leave of court to file a proof of claim beyond the bar date claiming that it did not receive notice of the conversion to Chapter 7 and the bar date, while the Bankruptcy Court found that the DER had actual knowledge of the Debtor's bankruptcy prior to the conversion date, nevertheless, the court granted the motion on August 9, 1994, because the trustee was not present during the hearing to determine liability of the claim beyond the bar date.

On August 19, 1994, the DER filed a proof of claim that the fine of $20,000 is an administrative claim under Section 726(a)(1) of Section 507(a)(1) of the Code.

On April 1, 1997, the trustee filed an objection to the proof of claim of the DER, alleging its administrative status. It is noted that the trustee does not dispute status of the fine as a subordinated unsecured claim under Section 726(a)(4) of the Code.

On appeal, in addition to raising the issue of the administrative expense status of the criminal fine of $20,000, the DER also appeals the holding of the Bankruptcy Court that its order granting the DER leave to file its proof of claim beyond the bar date was a nullity. This Court need not reach that issue.

Legal Discussion

On appeal from an order of the Bankruptcy Court, the district court must apply the clearly erroneous test of factual findings and plenary review to questions of law.

Moreover, mixed questions of law and fact must be divided into the respective components and the appropriate test applied. *In re: Brown,* 951 F.2d 564 (3d Cir. 1991).

After review of the record, the arguments and memoranda of the parties, the Court finds that the Bankruptcy Court's findings of fact are not clearly erroneous and the Bankruptcy Court did not err with regard to the applicable questions of law on the issue of the administrative status of the criminal fine.

The Court finds it is not necessary to reach the issue of whether the proper procedure for claiming the fine as administrative expense is to file a proof of claim for it, or to move for its allowance as an administrative expense pursuant to 11 U.S.C. § 503(a).

Therefore, an appropriate order dismissing the appeal will be entered.

Donald J. Lee, J.

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

COMMONWEALTH OF PENNSYLVANIA, DEPARTMENT OF ENVIRONMENTAL RESOURCES,	)	
Appellant,	)	Civil Action No. 97-2115
	)	Bankruptcy Court
vs.	)	No. 990-22476/JLC
TRI-STATE CLINICAL LABORATORIES, INC.,	)	
Appellee	)	

ORDER OF COURT

AND NOW, this 5th day of May, 1998, after hearing, it is hereby

ORDERED that the appeal of the Commonwealth of Pennsylvania Department of Environmental Resources is **DISMISSED.**

/s/ Donald J. Lee
Donald J. Lee
United States District Judge

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Clerk, U.S. Bankruptcy Court
Western District of PA

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

IN RE:	CASE NO. 90-22476 JLC
TRI-STATE CLINICAL LABORATORIES, INC.,	MOTION NO. N&M-12
Debtor,	
JOSEPH P. NIGRO, TRUSTEE,	CHAPTER 7
Movant / Objector,	
v.	OBJECTION TO CLAIM NO. 48
COMMONWEALTH OF PENNSYLVANIA, DEPARTMENT OF ENVIRONMENTAL RESOURCES	
Respondent / Claimant.	

MEMORANDUM OPINION

The matter before the court is Trustee Joseph P. Nigro Movant/Objector's objection to the proof of claim filed by Respondent/Claimant the Commonwealth of Pennsylvania, Department of Environmental Resources. The Respondent/Claimant contends that a criminal fine assessed postpetition should be given administrative expense status under Section 503 (b) of the United States Bankruptcy Code. For the reasons expressed below, the objection to proof of claim shall be sustained.

FACTS

On August 14, 1990, Tri-State Clinical Laboratories, Inc. ("Debtor") filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code ("Code"). On January 21, 1992, a criminal complaint was filed against the Debtor for violation of Pennsylvania's Solid Waste Management Act. Count I of the complaint accused the Debtor of unlawfully storing municipal waste on or about July 18, 1990. Count II of the criminal complaint stated that on or about October 4,

1990, the Debtor disposed of infectious waste in a municipal waste dumpster in violation of Pennsylvania's Solid Waste Management Act.

On September 10, 1992, Joseph P. Nigro was appointed Chapter 11 trustee. On October 6, 1992, the case was converted to Chapter 7 and again Joseph P. Nigro ("Trustee") was appointed the Chapter 7 Trustee on December 1, 1992. It appears that on July 28, 1994, the Debtor was found guilty on two counts of said violations before the Court of Common Pleas of Westmoreland County by default. It is this court's understanding that the Debtor ceased to operate around August of 1991. Nevertheless, the Trustee was not noticed as to the proceeding. Consequently, the Debtor, not the Trustee, was ordered by the Court of Common Pleas of Westmoreland County to pay a criminal fine in the amount of $10,000.00 on Count I and a criminal fine in the amount of $20,000.00 on Count II.

On June 1, 1994, the Commonwealth of Pennsylvania Department of Resources ("DER") filed a motion for leave of court to file proof of claim beyond the bar date claiming that it did not receive the notice of conversion to Chapter 7 and the bar date. The DER, however, had actual knowledge of the Debtor's bankruptcy prior to the conversion date. This is evidenced in its letter dated October 5, 1992 to then Chapter 11 Trustee Joseph P. Nigro which is attached as an exhibit to the Trustee's Response to the Motion to Allow Late Claim.

On August 9, 1994, this court granted the motion to allow claim beyond the bar date as the Trustee, despite having filed a written response, was not present during the hearing to determine allowability of claim beyond the bar date.

On August 19, 1994, the DER filed a proof of claim which states that the criminal fine of $ 10,000 assessed on Count I is a subordinated unsecured claim under Section 726 (a) (4) of the Code and the criminal fine of $20,000 imposed on Count II is an administrative claim under Section 726 (a) (1) and Section 507 (a) (1) of the Code.

On April 1, 1997, the Trustee filed an objection to the proof of claim filed by the DER. Only the $20,000 portion of the claim seeking administrative status for the criminal fine

imposed is in dispute. The amount and priority of the $10,000 assessed on Count I are not disputed.

Discussion

DER's Argument for Administrative Priority

The DER in arguing for administrative expense status of the criminal fine, cites 11 U.S.C. Section 503 (b) (1) (A) which provides that "the actual, necessary costs and expenses of preserving the estate," shall be allowed as an administrative expense. The DER submits six cases in support of giving administrative status to postpetition civil judgments, civil fines and civil penalties. On this basis, it argues that the criminal fine imposed postpetition for post petition activity of the debtor should also be accorded administrative status.

The DER states two principles relating to administrative status of postpetition tort claims which are set forth in *Reading Co. v. Brown,* 391 U.S. 471, 88 S.Ct. 1759 (1968). First, "tort claims arising during an arrangement are actual and necessary expenses of the arrangement." *Id.* at 482, S.Ct. at 1765. Second, there should be no distinction given in terms of priority "within the class of torts committed by receivers while acting in furtherance of the business, between those 'integral' to the business and those that are not." *Id.* at 485, S.Ct. at 1767.

The DER provides *In re Charlesbank Laundry, Inc.,* 755 F.2d 200 (1st Cir. 1985), which extends the application of the *Reading's* rationale from civil judgment to civil fine. On this point, the United States Court of Appeals for the First Circuit held that since "fairness dictates that a tort claim based on negligence should be paid ahead of pre-reorganization claims, then, *a fortiori,* an intentional act which violates the law and damages others should also be so treated." *Id.* at 203.

Additionally, DER submits *In re N.P. Mining Co. Inc.,* 963 F.2d 1449 (11th Cir. 1992), to show that a civil penalty assessed due to environmental violations incurred during Chapter 11, which was later converted to Chapter 7 was treated as an administrative priority. The United States Court of Appeals for the Eleventh Circuit held that "the penalties in question receive first priority, but only to the extent that they

were incurred as a consequence of mining operations after the bankruptcy petition was filed and while the business was still operating." *Id.* at 1453. The *N.P. Mining* court sets forth two statutory reasons for its holding. First, under 28 U.S.C. Section 959 (b), trustees must operate an estate in compliance with state law. *Id.* at 1453. Second, the word "including" in Section 503 (b) indicates that Congress did intend that first priority claims include claims other than those that serve to preserve the estate. *Id.* at 1456. Thus, the *N.P. Mining* court has held, that "in the regulated atmosphere of strip mining industry, a fine for the violation of environmental regulations should be considered a cost ordinarily incident to operation of a business." *Id.* at 1458; *See In re Bill's Coal Co., Inc.,* 124 B.R. 827, 830 (D.Kan. 1991).[1]

The DER argues that there should be no distinction made between civil fines and penalties because they are treated identically under 11 U.S.C. Section 726 (a) (4).[2] Accordingly, the DER argues that there should be no distinction made between a *criminal* fine and penalty. Therefore, the DER contends that the $20,000 criminal fine imposed on the debtor postpetition should be granted an administrative expenses status.

Trustee's Argument for Unsecured Status

The Trustee contends that the $20,000 criminal fine should be treated as an unsecured claim under 11 U.S.C. Section 726 (a) (4). He asserts that Congress has specifically shown an intent to exclude the actual amount of criminal fines

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1. DER offers two additional cases dealing, respectively, with civil penalties and punitive fines in which they were both found to have administrative priority. *See In re Motel Investments. Inc.,* 172 B.R. 105 (Bankr. M.D.Fla. 1994) and *In re Double B Distributors. Inc.,* 176 B.R. 271 (Bankr. M.D.Fla. 1994).

2. 11 U.S.C. Section 726 (a) (4) provides that property of the estate shall be distributed "fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;"

as administrative claims. The Trustee presents three primary arguments in support of his contention. First, Section 503 (b) (3) (C) limits administrative claims based upon criminal prosecutions to "'actual, necessary expenses incurred by a creditor "in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor." Second, the language of the Code in Section 503 (b) only mentions an exception to Section 503) (b) (3) (C) in the context of taxes, which is provided for in Section 503 (b) (1) (C). Third, Section 726 (a) (4) provides that administrative expenses have priority over fines and penalties.

The Trustee contends that specific language of the Code is controlling and to allow a criminal fine as an administrative expenses is contrary to the Congressional intent. The Trustee claims that Congress has shown an intent to exclude the actual amount of criminal fines from the ambit of administrative expenses. Furthermore, the Trustee suggests that this court should give consideration to the dissent in *Reading* who stated that the theme of bankruptcy should follow "equality in distribution, and if one claimant is to be preferred over others, the purpose should be clear from the statute." *Reading Co, v. Brown,* 391 U.S. 471, 486, 88 S.Ct. 1759, 1767 (1968). Thus, without clear language in the Code relating to criminal fines, the Trustee argues that courts should not infer beyond what is provided for in the Code.

The Trustee also points out that none of the cases that the DER relies on have applicability to this case because they are all decided in the context of a civil fine or civil penalty. Thus, the Trustee argues that the case law cited by the DER is distinguishable and this court is not bound by those holdings.

Analysis on allowance of late claim

Prior to examining the merits of this matter, the court has reviewed the procedural history of the claim.

This court finds that the DER filed an inappropriate motion for its claim against the estate. Since the DER is claiming administrative expense status for its judgment against the Debtor, the DER's motion should have been based on Section 503 which governs allowance of administrative expenses. On

allowance of administrative expenses, Section 503 (a) provides that "[a]n entity may timely file a request for payment of an administrative expense or may tardily file such request if permitted by the court for cause." The DER, however, instead of filing a motion to allow administrative expenses claim, filed an improper motion (i.e. motion for leave of court to file proof of claim beyond the bar date). Thus, this court's order granting the DER leave to file its proof of claim beyond the bar date is, in effect, a nullity.

Additionally, even if the DER filed the proper motion based on Section 503, this court finds for the reasons below that the $20,000 criminal fine is not an administrative claim, but an unsecured claim.

Analysis on administrative priority issue

The standard for allowing an administrative expense is set forth in 11 U.S.C. Section 503 (b) (1) (A):

> (b) After notice and a hearing, there shall be allowed, administrative expenses, . . . including —
>
> (1) (A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. . . .

The United States Supreme Court has held that "actual and necessary costs should include costs ordinarily incident to operation of a business, and not be limited to costs without which rehabilitation would be impossible." *Reading Co. v. Brown,* 391 U.S. 471, 483, 88 S.Ct. 1759, 1766 (1968).

Therefore, pursuant to Section 503 (b) and the *Reading* case, the pertinent issue to be decided here is whether a non-compensatory criminal fine that is assessed postpetition is a cost ordinarily incident to operation of a business within the meaning of Section 503 (b).

Within the Third Circuit the issue of a claim under Section 503 (b) has been addressed in the cases of *In re Conroy.* 144 B.R. 966 (Bankr. W.D.Pa. 1992), *aff'd in part and rev'd in part,* 153 B.R. 686 (W.D.Pa. 1993), *aff'd,* 24 F.3d 568 (3d Cir. 1994).

The facts of the *Conroy* case are as follows: The DER ordered Conroy to remove the hazardous materials and he failed to comply. *Com. of Pa.. Dept. of Env. Resources v. Conroy* 24 F.3d 568, 569 (3d Cir. 1994). Conroy filed a Chapter 11 petition in October 1990, and a few moonths later, the DER engaged a private contractor who began to clean up the site. *Id.* Two costs regarding this clean up were at issue as to whether they should be given an administrative priority status: (1) response costs; and (2) administrative and legal costs concerning the clean up. *Id.*

In construing Section 503 (b) and administrative priority status thereof, the United States Bankruptcy Court for the Western District of Pennsylvania stated that "in order for an expenditure to qualify as 'actual' and 'necessary,' it must benefit the estate as a whole, not just the creditor/claimant." *In re Conroy,* 144 B.R. 966, 969 (Bankr. W.D.Pa. 1992). Additionally, the court found that "[t]he terms 'actual' and 'necessary' in this context must be strictly construed." *Id.* Thus, as to response costs, the court found that "[t]he bankruptcy estate thereby was benefitted to the extent that action which was required under the law — i.e. remediation — was performed on its behalf by another party." *Id.* at 971. As to administrative, and legal costs, however, the court found that such costs go beyond the actual cost of remediating the problem and found that such costs were arbitrary surcharges. *Id.*

The district court affirmed the analysis on response costs but disagreed with the analysis on administrative and legal costs. *In re Conroy,* 153 B.R. 686, 693 (W.D.Pa. 1993). The district court found that "[t]he Supreme Court has not construed the meaning of administrative expenses narrowly," and also determined that the analysis on administrative and legal costs by the bankruptcy court "ignores that there are other policies also involved in Section 503 (b)." *In re Conroy,* 153 B.R. 686, 691 (W.D.Pa. 1993); *See also Reading Co. v. Brown,* 391 U.S. 471, 484-485, 88 S.Ct. 1759, 1766, *In-re N.P. Mining Co. Inc.,* 963 F.2d 1449, 1454. As to the other policies, the district court in *Conroy* cites 28 U.S.C. Section 959 (b) which mandates that a trustee follow the state law including the law

that provides for recovery of administrative and legal costs.[3] *Id.* at 692. Thus, the court found that "the bankruptcy court applied an incorrect legal standard in denying DER's request for a [administrative and legal] costs pursuant to [Pennsylvania statute dealing with recovery of administrative and legal costs]." *Id.*

Additionally, the court held that these additional costs "represents real and actual administrative and legal costs incurred by DER." *Id.* The court, however, qualified its holding by stating that the administrative and legal costs in this case are "compensatory in nature." *Id.* at 692, n.2. As to hypothetical non-compensatory costs, the court did not offer a guideline but suggested that awarding a non-compensatory costs would conflict with the established doctrine of administrative expense status for environmental clean up costs. *Id.* at 692, n.2; *See generally In re N.P. Mining Co. Inc.,* 963 F.2d 1449, 1458 (11th Cir. 1992) (stating that a fine need not be a compensatory one).

On appeal, the Third Circuit did not address on the non-compensatory costs issue and affirmed on the grounds that the administrative and the legal costs along with the response cost were compensation for actual and necessary expenses for preserving the estate under Section 503 (b). *Com. of Pa.. Dept. of Env. Resources v. Conroy,* 24 F.3d 568, 570-571 (3d Cir. 1994) The Third Circuit court in *Conroy* had two grounds on which to affirm the district court, 28 U.S.C. Section 959 (b) and 11 U.S.C. Section 503 (b).[4] The decision was affirmed, however, only on the basis of Section 503 (b).

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3. Title 28 U.S.C. Section 959 (b) provides that "...a trustee... appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof."

4. Although the district court in *Conroy* did not cite Section 503 (b) for its holding on the associated administrative and legal costs, this court takes the district court's holding that such costs were "real and actual administrative and legal costs incurred by DER" to be adequate to determine that the holding was based on Section 503 (b). *See In re Conroy,* 153 B.R. 686, 692.

The Third Circuit court's apparent reluctance to base its holding on Section 959 (b) is evidenced in the following holding.

> [W]e think that the amount of the award in this case ... was sufficiently substantiated ... [T]he Pennsylvania legislature apparently concluded that the DER's 'administrative and legal costs' will generally amount to 10% of the amount paid for the response action or the actual costs, whichever is greater. This implicit legislative Finding is reasonable, and we believe that it is sufficient to satisfy the DER's burden of proving its entitlement to these administrative expenses. While the Conroys and other interested parties could certainly have attempted to show that the 10% figure was excessive in this case, the Conroys have not directed our attention to any such evidence. Moreover, there is evidence in the record that tends to substantiate the reasonableness of the amount awarded.

Id. at 571.

The Third Circuit could have held that Conroy must pay as an administrative expense pursuant to Section 959 (b) regardless of whether or not the DER could reasonably substantiate its administrative and legal costs. The Third Circuit court, however, suggested that Conroy had an opportunity to rebut the statutory presumption by showing that the costs were excessive. In other words, the Third Circuit court seems to indicate in its holding a willingness to disallow the DER's claims to the extent that the claim is non-compensatory. Therefore, it is inferred from this case that the Third Circuit based its decision on Section 503 (b) because a compensatory and non-compensatory distinction comports with the statutory language of Section 503 (b) that "the actual, necessary costs and expenses of preserving the estate" shall be allowed as administrative expenses.

In the instant case, there was no governmental action to clean up the waste produced by the Debtor even though the

DER fully knew of the location of the waste. Instead, the DER fined the Debtor an amount that has no connection with the clean up costs. Had this been a cost directly associated with the environmental remediation, it would clearly be a compensatory cost within the context of *Conroy.* As a criminal fine which has no association with the actual cleanup costs, however, It is strictly a non-compensatory expense.

Therefore, this court holds that the criminal fine which is not associated with the clean up costs is not an administrative claim under Section 503 (b) based on the Third Circuit's holding in *Conroy. Id.* at 571.

Section 503 (b) gives consideration to the statutory objective that was decisive in the *Reading* court's holding: "fairness to all persons having claims against the insolvent." 391 U.S. 471, 477, 88 S.Ct. 1759, 1763 (1968). Pursuant to such objective, the *Reading* court analyzes the positions of the victims of the negligence of the receiver and creditors and concludes that "the present [claimant] did not merely suffer injury at the hands of an insolvent business: it had an insolvent business thrust upon it by operation of law." *Id.* a at 478, 88 S.Ct. 1763. In furtherance of that the *Reading* court finds as follows:

> The "master," liable for the negligence of the "servant" in this case was the business operating under a Chapter XI arrangement for the benefit of creditors and with the hope of rehabilitation. That benefit and that rehabilitation are worthy objectives. But it would be inconsistent both with the principle of respondent superior and with the rule of fairness in bankruptcy to seek these objectives at the cost of excluding tort creditors of the arrangement from its assets, or totally subordinating the claims of those on whom the arrangement is imposed to the claims of those for whose benefit is instituted.

Id. at 479, 88 S.Ct. 1764.

Only after this "fairness" analysis, the *Reading* court reaches the holding that "actual and necessary cost should include costs ordinarily incident to operation of a business,

and not be limited to costs without which rehabilitation is impossible." *Id.* at 484, 88 S.Ct. at 1766.

Debtors in possession and trustees are required to obey the laws during the administration of the case. When they fail by ignorance or deliberate willfulness, the consequence requires careful analysis. 11 U.S.C. Section 503 (b) requires the administrative expenses to benefit the estate by being necessary and actual. Breaking the law regarding disposal of waste is not necessary for the administration of the estate and the criminal fines an not actual expenses related to specific cleanup. Government environmental agencies such as ASMC (the Alabama Surface Mining Commission, the appellant in *N.P. Mining*) and the DER are not helpless parties who had insolvent businesses thrust upon them by operation of law. Rather they are in a better position than the Chapter 11 creditors to monitor and prevent environmental violations because (1) they have police power to enforce the statutory environmental requirement; and (2) they are in a position to protect their interest through legislation.

Thus, this court finds that a compensatory and non-compensatory distinction is appropriate in determining whether a claim should be accorded an administrative status in an environmental cleanup case under Section 503 (b). The criminal fine imposed did not go toward compensating DER for any administrative, legal or other costs directly associated with any environmental remediation. Creditors should not be forced to bear this burden, particularly when the expense is non-compensatory and does not benefit the estate. The court must encourage the collection of assets and the maximization of distribution to all creditors. The use of the criminal law to discourage the offenses by fines has wide discretion. To classify these as administrative expenses discourages the collection of assets and reduces distribution to all creditors.

Conclusion

For the reasons expressed above, this court finds that the criminal fine assessed postpetition for postpetition conduct is not an administrative expense under Section 503) (b). Accordingly, the Trustee's objection to proof of claim is sustained.

An appropriate order shall be entered.

On this 21st day of August, 1997
At Pittsburgh, Pennsylvania

/s/ Joseph L. Cosetti
Joseph L. Cosetti
U.S. Bankruptcy Judge

cc: MATTHEW M. POVLOVICH, ESQUIRE
Nigro & Malley
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Pittsburgh, PA 15222

STUART M. BLIWAS, ESQUIRE
PA Dept of Environmental Protection
400 Market Street, P.O. Box 8464
Harrisburg, PA 17105-8464

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

IN RE:	CASE NO. 90-22476 JLC
TRI-STATE CLINICAL LABORATORIES, INC.,	MOTION NO. N&M-12
Debtor,	
JOSEPH P. NIGRO, TRUSTEE,	CHAPTER 7
Movant / Objector,	
v.	OBJECTION TO CLAIM NO. 48
COMMONWEALTH OF PENNSYLVANIA, DEPARTMENT OF ENVIRONMENTAL RESOURCES	
Respondent / Claimant.	

ORDER OF COURT

AND NOW this 21st day of **August, 1997,** for the reasons expressed in the Memorandum Opinion of the same date, it is **ORDERED, ADJUDGED and DECREED** that the $20,000 criminal fine assessed for postpetition conduct is not an administrative claim under Section 503 (b) of the the United States Bankruptcy Code and the claim shall be allowed as an unsecured claim.

/s/ Joseph L. Cosetti
Joseph L. Cosetti
U.S. Bankruptcy Judge

cc: MATTHEW M. POVLOVICH, ESQUIRE
Nigro & Malley
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Pittsburgh, PA 15222

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PA Dept of Environmental Protection
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No. 98-3332

United States Court of Appeals for the Third Circuit

COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF ENVIRONMENTAL RESOURCES,

Appellants,

v.

TRI-STATE CLINICAL LABORATORIES, INC.,
JOSEPH NIGRO, *Trustee,*

Appellees.

SUR PETITION FOR REHEARING

Present: BECKER, *CHIEF JUDGE,*
SLOVITER, MANSMANN, GREENBERG, SCIRICA,
NYGAARD, ALITO, ROTH, McKEE and RENDELL
Circuit Judges.

The petition for rehearing filed by Appellant's in the above entitled case having been submitted to the judges who participated in the decision of this court and to all other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT,
/s/ Theodore A. McKee
Circuit Judge
Hon. Theodore A. McKee

July 21, 1999

11 U.S.C. § 503

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including –

(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;

(B) any tax –

(i) incurred by the estate, except a tax of a kind specified in section 507(a)(7)(8) of this title; or

(ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after the commencement of the case; and

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;

(2) compensation and reimbursement awarded under section 330(a) of this title;

(3) the actual, necessary expenses, other than compensation and reimbursement specified in paragraph (4) of this subsection, incurred by

(A) a creditor that files a petition under section 303 of this title:

(B) a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor:

(C) a creditor in connection with the prosecution of a criminal offense relating to the case or to the business or property of the debtor

(D) a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title;

(E) a custodian superseded under section 543 of this title, and compensation for the services of such custodian; or

(F) a member of a committee appointed under section 1102 of this title, if such expenses are incurred in the performance of the duties of such committee:

(4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant;

(5) reasonable compensation for services rendered by an indenture trustee in making a substantial contribution in a case under chapter 9 or 11 of this title, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title; and

(6) the fees and mileage payable under chapter 119 of the title 28 [28 U.S.C. §§ 1821 et. seq.].

Former Bankruptcy Act –

§ 57(j), 11 U.S.C. § 93 (j) (repealed 1978):
Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

§ 64a(l), 11 U.S.C. § 104(a)(1) (repealed):
a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition.